

ECONOMICS

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Ten Principles of Economics

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WHAT IS ECONOMICS?

- Every field of study has its own terminology
 - Mathematics: Integrals – axioms - vector spaces
 - Psychology: Ego – id - cognitive dissonance
 - Law: Promissory – estoppel – torts – venues
- Many of the concepts you will come across in this economics are abstract.
- Abstract concepts are ones which are not concrete or real – they have no tangible qualities.

WHAT IS ECONOMICS?



➤ Economics trains you to. . . .

- Think in terms of alternatives.
- Evaluate the cost of individual and social choices.
- Examine and understand how certain events and issues are related.

THE ECONOMY AND ECONOMIC SYSTEMS

- The economy is all the production and exchange activities that take place every day.
- Economics is the study of how society manages its scarce resources.
- Economic activity is how much buying and selling goes on in the economy over a period of time.



THE ECONOMY AND ECONOMIC SYSTEMS

- In the economy we are faced with many decisions many involving an exchange sometimes using money as the medium.
 - Households purchase final goods and services for final consumption and also provide the inputs into production – land labor and capital
 - The organisations which buy these factors and use them to produce goods and services are referred to collectively as firms.



THE ECONOMY AND ECONOMIC SYSTEMS

- A household and an economy face many decisions:
 - Who will work?
 - What goods and how many of them should be produced?
 - What resources should be used in production?
 - At what price should the goods be sold?

HOW THE ECONOMY AS A WHOLE WORKS

- **Microeconomics** is the study of how households and firms make decisions and how they interact in markets.
- **Macroeconomics** is the study of economy-wide phenomena, including inflation, unemployment and economic growth.



Principle #1: People Face trade-offs.

- To get one thing, we usually have to give up another thing.
 - Food v. clothing
 - Leisure time v. work
 - Efficiency v. equity
- ✓ *Making decisions requires trading off one goal against another.*

Principle #1: People Face trade-offs.

➤ Getting the most from scarce resources:

- Technical efficiency
- Productive efficiency
- Allocative efficiency
- Social efficiency

Decision making involves trade-offs.

Principle #1: People Face trade-offs.

➤ Efficiency v. Equity

- *Efficiency* means society gets the most that it can from its scarce resources.
- *Equity* means the benefits of those resources are distributed fairly among the members of society.
- **Efficiency** refers to the size of the economic cake and **equity** refers to how the cake is divided.

Principle #2: The Cost of Something Is What You Give Up to Get It.

- Decisions require comparing costs and benefits of alternatives.
 - Whether to go to university or to work?
 - Whether to study or go out on a date?
 - Whether to go to class or sleep in?
- The *opportunity cost* of an item is what you give up to obtain that item. It is whatever is given up to obtain some item. It measures the value of what is foregone.

Principle #3: Rational People Think at the Margin.

- *Marginal changes* describe small incremental adjustments. They are small, incremental adjustments to an existing plan of action.
- Many decisions are made at the margins
- Firms are interested in the marginal costs
- ✓ *Peoples make decisions by comparing costs and benefits at the margin.*

Principle #4: People Respond to Incentives.

- People compare the costs and benefits when making decisions.
- Decisions are made by
 - people as **consumers**,
 - businesses as **suppliers** and
 - governments as **policy makers**

Principle #4: People Respond to Incentives.

- Marginal changes in costs or benefits motivate people to respond.
- The decision to choose one alternative over another occurs when that alternative's marginal benefits exceed its marginal costs!
- Public policies can create incentives or disincentives that alter behaviour.

Principle #5: Trade Can Make Everyone Better Off.

- People gain from their ability to trade with one another.
- Competition results in gains from trading.
- Trade allows people to specialize in what they do best.
 - Sometimes this leads to people losing their jobs as production moves overseas.



Principle #5: Trade Can Make Everyone Better Off.

- Countries as well as businesses benefit from the ability to trade with one another.
- Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services.



Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- A *market economy* is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.
- Pure market economy has no government intervention.
 - Households decide what to buy and who to work for.
 - Firms decide who to hire and what to produce.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- *Centrally planned economy* is where those in charge guide economic activity.
 - They have failed because they did not allow the market to work.
- Some countries adopted central planning, but these have been abandoned in favour of markets.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- In a market economy, the decisions of a central planner are replaced by the decisions of millions of firms and households.
- In general, markets have promoted economic well-being.
- Markets are not without their problems.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- Adam Smith made the observation that households and firms interacting in markets act as if guided by an “invisible hand.”
 - Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social costs of their actions.
 - As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.

Principle #7: Governments Can Sometimes Improve Market Outcomes.

- *Market failure* occurs when the market fails to allocate resources efficiently.
- When the market fails government can intervene to promote efficiency and equity.
- Market failure may be caused by
 - an *externality*, which is the impact of one person or firm's actions on the well-being of a bystander.
 - *market power*, which is the ability of a single person or firm to unduly influence market prices.

Principle #8: An Economy's Standard of Living Depends on its ability to produce goods and services.

- *Economic growth* - the increase in the amount of goods and services in an economy over a period of time.
- *Gross domestic product per head* - the market value of all final goods and services produced within a country in a given period of time divided by the population of a country to give a per capita figure.

Principle #8: An Economy's Standard of Living Depends on a Country's Production.

- *Standard of living* - a measure of welfare based on the amount of goods and services a person's income can buy.
 - Usually measured by the inflation adjusted (real) income per head of the population.
 - Most variations in living standards are explained by differences in countries' productivities.
- *Productivity* is the amount of goods and services produced from each hour of a worker's time.

Principle #9: Prices Rise When the Government Prints Too Much Money.

- *Inflation* is an increase in the overall level of prices in the economy. Inflation measures the overall increase in prices.
- One cause of inflation is the growth in the quantity of money.
 - When the government creates large quantities of money, the value of the money falls.
 - Printing money leads to price rises, because the value of money falls
 - High inflation imposes various costs on society.

Principle #10: Society Faces a Short-run trade-off Between Inflation and Unemployment.

- *The Phillips Curve* illustrates the trade-off between inflation and unemployment:

↓ Inflation ⇔ ↑ Unemployment

It's a short-run trade-off!

- Increase the money supply and therefore inflation can lower unemployment in the short-term.
- The short-term can last several years.

Principle #10: Society Faces a Short-run trade-off Between Inflation and Unemployment.

- Economies undergo irregular and largely unpredictable fluctuations or cycles in economic activity.
- *Business cycle* is the fluctuations in economic activity, such as employment and production.



Summary

1. When individuals make decisions, they face trade-offs among alternative goals.
2. The cost of any action is measured in terms of foregone opportunities.
3. Rational people make decisions by comparing marginal costs and marginal benefits.
4. People change their behavior in response to the incentives they face.

Summary

- 5. Trade can be mutually beneficial.
- 6. Markets are usually a good way of coordinating trade among people.
- 7. Government can potentially improve market outcomes if there is some market failure or if the market outcome is inequitable.

Summary

- 8. Productivity is the ultimate source of living standards.
- 9. Money growth is the ultimate source of inflation.
- 10. Society faces a short-run trade-off between inflation and unemployment.



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Teşekkürler !

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